COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS & ENERGY

Petition of Bay State Gas Company for	**}**
Authority to Establish a Gas Cost	**} D.T.E. 01-81**
Incentive Mechanism	**}**

INITIAL BRIEF OF
ALLENERGY GAS & ELECTRIC MARKETING COMPANY, L.L.C.

PUBLIC VERSION

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I. INTRODUCTION

In this proceeding, Bay State Gas Company ("Bay State" or "the Company") asks the Department of Telecommunications and Energy (the "Department") to abandon its long standing commitment to the development of competition for those aspects of utility service that can be provided in a competitive marketplace. Bay State seeks in this proceeding the right to offer, as the local distribution company ("LDC") monopoly, a competitive service that is subsidized with monopoly ratepayer funds and otherwise violates the Department's protections against anticompetitive conduct by entrenched monopolists. The service for which Bay States seeks approval will compete directly with competitive suppliers who have entered the Massachusetts market based on the Department's express policy pronouncements advocating competition and specific rules protecting against anticompetitive conduct.

The Department's approval of Bay State's proposal would signal an end to the Department's support of competition enabling policies and render meaningless the protections against anticompetitive conduct established in its precedent and codified in 220 CMR 12.00 *et seq*. Such a signal would not be lost on other Massachusetts LDCs also looking for additional revenue sources. At the same time, approval of Bay State's program would undermine the confidence that competitive suppliers need to enter the local market and simultaneously create incentives for Bay State (and eventually other LDCs) to further impede the development of competition. The Department should reject Bay State's proposal.

This proceeding is the investigation by the Department into the propriety of the proposal set forth by Bay State to implement a Gas Cost Incentive Mechanism, ("GCIM"). The Department opened an investigation into Bay State's proposal on December 4, 2001. AllEnergy

Gas & Electric Marketing Company, LLC ("AllEnergy") is a Supplier that serves retail natural gas customers on 28 distribution companies in the northeast, including the Bay State system.

The Company's filing seeks authorization to establish a GCIM for an initial three-year period, under which Bay State will be allowed to earn a monetary incentive if it is able to achieve or surpass certain benchmark prices in its purchase of gas commodity. The cost of purchases subject to the GCIM could include the cost of physical gas and/or financial instruments locking in a specific price for the commodity. The plan is intended to apply to domestic commodity purchases for all firm sales service customers. Potential gas cost savings come from implementing strategies that are already available to Bay State, such as timing of storage injections. The remainder of potential savings are to be derived from the use of ratepayer revenues and usage to speculate on price in the natural gas commodity markets for profit.

For the reasons set forth below, AllEnergy requests that the Department reject the Company's proposed GCIM.

II. BAY STATE'S PROPOSAL VIOLATES THE DEPARTMENT'S RULES REGARDING INCENTIVE REGULATION, THE PROMOTION OF COMPETITION, AND COMPETITIVE AFFILIATE RELATIONSHIPS WITH THE MONOPOLY LDC.

Bay State asserts that its proposal is designed to bring lower gas costs to customers, and is the next logical step in incentive ratemaking. Ex. BSG-3, at 2, 3, 14. In fact, Bay State's proposal is designed to allow the Company to earn an incentive on one aspect of merchant service while insulating the Company from all other risks. It proposes to do so by having the Department assign customers from its monopoly merchant service to this new program, while incurring no customer acquisition costs. At the same time, Bay State ignores the Department's goals for competition (Investigation into Unbundling of Gas LDC's Services, D.T.E.98-32-B (1999) at 4.), the Department's criteria for evaluating incentive proposals (Incentive Regulation, D.P.U. 94-158), and the Department's rules governing relations between an LDC and its competitive affiliates. Standards of Conduct Rulemaking, D.P.U. 96-44 (December 30, 1996); 220 CMR 12.00 *et seq*. Bay State's proposal flies in the face of all three.

A. Under Department Precedent, Incentive Regulation Is Inappropriate Where A Competitive Market Exists.

The Department's goals for competition are clear that incentive regulation should be relied upon only when "… a competitive market cannot exist, or does not exist." Investigation into Unbundling of Gas LDC's Services, D.T.E.98-32-B (1999) at 4. The facts demonstrate that there is active competition in the commercial and industrial merchant service markets on Bay State's system, including the small customer classes. Ex. AE 1-4, RR AE-2, RR DTE-8 (Protected)). New customers are being acquired, even with capacity assignment. Ex. AE 1-4, Tr. 3, at 325-326. Twenty-one percent of Bay State's commercial and industrial customers and 61 percent of C/I load have migrated to the competitive market. Exh. AE 1-4; AllEnergy Ex. 1, p. 6. AllEnergy concedes that there is no competition in residential markets, nor is there likely to be in the near future due to numerous barriers to a residential program. However, Bay State declined to limit its proposal to a residential-only program, despite three attempts during hearings to obtain Bay State's consent to such a limitation.[1] Tr. 1, at 159, 205, 217. Where Bay State's proposal encompasses all firm sales markets, including commercial and industrial customers, and where clearly the commercial and industrial merchant service markets are competitive, Bay State's incentive proposal fails the Department's articulated conditions under which incentive regulation is appropriate. Bay State's proposal should be rejected on that basis alone.

[1] Despite the theoretical attractiveness of isolating Bay State's proposal to the residential class, as a practical matter, Bay State does not isolate specific resources in its portfolio and designate them for a specific class. It operates the portfolio as a whole. Therefore, even isolating the proposal to the residential class could prove to be problematic.

B. Bay State's Proposal Is Not A Vehicle To A More Competitive Market and Does Not Comply with the Department's Criteria for Incentive Ratemaking.

In Incentive Regulation, D.P.U. 94-158 (1995), the Department established several criteria for evaluating an incentive proposal. "Consistency with Market-Based Regulation and Enhanced Competition" is one of the most critical of the criteria. The Department stated:

> *Incentive mechanisms must complement the ongoing movement towards a more market-based utility framework.* Fundamental changes in the marketplace for energy services likely will result in lower costs and the provision of more highly valued services – two of the Department's central objectives. *Where customer choice can be enhanced, the Department will continue to rely on expanding the number of market-based solutions.*

Id., at 58 (emphasis added). Noting the need for monopoly providers in the non-competitive aspects of utility service, the Department recognized the importance of protecting against the exercise of monopoly power in the competitive service areas:

> The Department recognizes, however, that competitive markets cannot be relied upon for every aspect of utility service (*e.g.*, transmission and distribution). Where competitive markets do not exist, the Department continues to recognize its obligation to oversee and protect against the detrimental exercise of market power, albeit through more flexible regulatory mechanisms than have been relied upon to date. *Incentive proposals should be designed as a vehicle to a more competitive environment* and to improve the provision of *monopoly* services.

Id., at 58-59 (emphasis added). Finally, the Department made clear that the LDC proposing an incentive plan bears the burden of demonstrating that its proposal is "consistent and/or complementary with the transition toward a more competitive market for energy services" and "avoid[s] the cross-subsidization of competitive services by revenues derived from the provision of monopoly services." *Id.*, at 59.

Bay State's proposal fails the Department's criteria that an incentive proposal should be consistent with market-based regulation and enhanced competition. In fact, Bay State's proposal intends to allow it to compete directly with suppliers, without having to incur many of the expenses a supplier must incur, without having to persuade customers to affirmatively select the service, and relying on services funded by Bay State's base rates. As such, Bay State's proposal is a classic example of cross subsidization of a competitive service and an obstacle to the development of a competitive market.

1. Given The Weak Support Of Competitive Markets Provided By Bay State Under NiSource, The Department Should Not Provide Bay State With Financial Incentives To Further Thwart The Development Of Competition.

Bay State's support of competitive markets, since its acquisition by NiSource, has diminished. Exh. BSG-AE-6, Tr. 3, at 301-302, 305. Bay State began its pilot program prior to its acquisition by NiSource and facilitated the success of the program through the implementation of a well-designed non-daily metered program, education efforts with its customers, advertising and other media support. Tr. 3, at 300, 301. Bay State also offered a number of services to suppliers, including billing services and call center services. Tr. 3, at 301. Coincident with the acquisition of Bay State by NiSource, however, services supporting competitive suppliers deteriorated. NiSource introduced its "customer service" system for Bay State and failed to support its pilot program. Tr. 3, at 301; Exh. BSG-AE-6. Subsequently, due to lack of support, the pilot program failed, as suppliers turned their customers back to Bay State's sales service. Tr. 3, at 301, 302.

Bay State's withdrawal of support for the competitive market after its acquisition by NiSource occurred at a time when Bay State was merely financially *indifferent* to the prospect of a customer switching to a supplier. Under Bay State's proposed GCIM, Bay State will earn incentive payments on merchant service and will no longer be financially indifferent. Bay State will have a financial incentive to impede migration to competitive suppliers. Such a prospect is not a positive one for the market. Tr. 3, at 310, 311. In fact, lack of LDC support can ruin a market as evidenced by the pilot program debacle. Exh. BSG-AE-6. It would be ironic indeed if the Department were to grant incentives to Bay State for serving a market that would have been served by competitive suppliers but for Bay State's poor support of competition. The Department should not reward the Company by allowing it to earn incentives in a market whose demise it contributed to.

It is essential that the LDC not have an incentive to interfere with the acquisition of customers by competitive suppliers. Even though there are detailed tariffs in place that govern the rules under which LDCs and suppliers interact, detailed procedures and practices are not specified. There is still much room for LDC discretion.

> Existing terms and conditions are only a piece of the program. They provide certain guidelines to a company under which it operates. But there are a number of other details that underlie those terms and conditions to make a program work. Those are the ones I am concerned about.
>
> There are issues of timing associated with certain things. There are issues of performance…

Tr. 3 at 321 (Witness Bachelder). Suppliers have experienced various levels of service from different LDCs, including Bay State, and the successful programs are well supported by the LDC. Tr. 3, at 308-309; RR DOER-5. As the record demonstrates, Bay State does not fall into the good service group. BSG-AE-6; Tr. 3, at 305. Bay State conceded that programs which inhibit or prohibit the establishment of a competitive market will make customers worse off. Tr. 2, at 199. Nevertheless, it persists with a proposal that provides incentives that conflict with the support of the competitive market and supplier services.

The Department should not countenance the long term strategy of Bay State's parent company to extend its monopoly position into the competitive merchant function. Bay State's parent company has no intention of exiting the merchant function. In fact, it intends to use its monopoly power to compete with suppliers and earn incentives while doing so. In a similar proceeding in Indiana, NiSource's representatives made that very clear.

> Mr. Yundt stated that Northern Indiana does not intend to abandon its merchant function…. In short, Northern Indiana wanted to be a player in the customer choice arena… Mr. Yundt testified that Northern Indiana's ARP will give suppliers increased access to Northern Indiana's traditional sales market while at the same time permit Northern Indiana to implement new services which can compete with these new market entrants.

AG 2-1 Attachment 181PUR4th, p. 12. NiSource considers suppliers as competitors and, if the Department allows Bay State to earn an incentive on sales service, it will no longer be financially indifferent as to whether a customer remains on sales service or switches to a competitive supplier. Tr. 3, at 311. Bay State's proposal and level of incentives are predicated on the captive sales volumes that they serve. Active suppliers are a threat to the maintenance of the size of that base. The Company will have every incentive to pull resources away from the support of competitive markets, and has shown that to be a viable threat through their past performance.

2. Bay State Is Developing A New Competitive Product And Is Asking The Department To Assign A Ready-Made Customer Base With Which To Earn Incentives.

Bay State's proposal puts the Company in a position to earn a tidy profit. It is already performing at target, even before implementing a GCIM. Ex. AE-1, at. 9, 10. Bay State's witness, Mr. DaFonte, indicates that Bay State will be using strategies used by its sister company NIPSCo for its own GCIM. Tr. 2, at 80-81, 145-147. If it performs at the level experienced by NIPSCo, it stands to earn approximately <BEGIN PROTECTED> XXXXXXXXXXX <END PROTECTED> annually,[2] an enviable profit position from a supplier's standpoint. The size of this incentive is also quite large – a <BEGIN PROTECTED> XX <END PROTECTED> percent

[2] See Table 1, below, which includes protected data.

increase in Earnings Before Interest and Taxes ("EBIT") – when it is compared to Bay State's 2001 EBIT of $33 million as reported in its 2001 annual return to the Department. AG 1-31, p. C1.

Table 1
USES PROTECTED DATA
Bay State Potential Savings
Using NIPSCO GCIM as a Comparison

	$	**Source**
Commodity Difference – Benchmark vs. NIPSCO purchases	<PROTECTED>	Attachment DOER 1-18 (PROTECTED)
NIPSCO Commodity Dollars	PROTECTED>	Attachment DOER 1-18 (PROTECTED)
Benefit as % Commodity	<PROTECTED>	Derived from Protected Data
<u>Bay State Annual Commodity $$</u>		
804 Natural Gas City Gate Purchases	211,872,666	AG 1-31 BSG Annual Return to Department 2001
808 Storage	10,154,570	"
806 Deferred	<u>25,829,651</u>	"
Estimated Pipeline & Storage Costs	247,856,887	
Less: Estimated Demand Charges Assumes 50%	123,928,444	
Estimated Commodity Charges	123,928,444	
Benefit by applying NiSource % Benefit	<PROTECTED>	Derived from Protected Data
Bay State portion (75%)	<PROTECTED>	Derived from Protected Data
Incentive as Percent of Gas Costs	<PROTECTED>	Derived from Protected Data
Bay State 2001 EBIT	$ 33,170,454	AG 1-31 BSG Annual Return to Department 2001
Incentive as Percent of EBIT	<PROTECTED>	Derived from Protected Data

A supplier would incur customer acquisition costs, customer administration costs, billing costs and costs associated with volume risk that would be net against that gross margin, and a supplier would not be guaranteed 100 percent participation. Tr. 3, at 151, 155; Ex. AE-1, at 8, 11. Bay State, however, is able to utilize its monopoly position to cover or avoid all of these costs, as even Bay State itself concedes. Tr. 2, at 151-152, 154-155, 159, 161-164; Tr. 3, at 151, 155; Exh. AE-1, at 8, 11. As a result, the earning potential from the sale of gas for a supplier that is just as efficient as Bay State in purchasing gas would be significantly less. The playing field this proposal creates is extremely uneven and is a blatant use of monopoly power.

The size of the potential benefit could also explain Bay State's reluctance to adjust its proposal to apply only to the residential classes. Bay State wants the additional volume and potential earning power afforded by commercial and industrial loads, where it will compete directly with suppliers.

> Q. Now, just so we understand the operation of the GCIM and its potential impact, I take it that the larger the volumes are of gas that Bay State sells to customers subject to that proposal, the larger the potential for gains are; is that correct?
>
> A. [Bryant] Certainly in any transaction, the potential for gains or potential for losses are certainly increased if the volumes associated with those transactions are increased.

Tr. 2, at 167. As shown in Table 2 below, limiting Bay State's proposal to the residential class would diminish its earning power by 27 percent. It would also close out the potential of the other 61 percent (14 Bcf) (Ex. AE-1, at 6; AE 1-4) of the commercial and industrial load that is taking service from suppliers.

Table 2
Bay State Sales Volumes
2001

	Residential Sales (MMBtu)	Commercial/ Industrial Sales (MMBtu)	Total Sales (MMBtu)
Jan-01	5,000,434	1,834,902	6,835,336
Feb-01	4,219,442	1,541,390	5,760,832
Mar-01	4,168,332	1,455,835	5,624,167
Apr-01	3,095,487	1,145,855	4,241,342
May-01	1,085,277	468,769	1,554,046
Jun-01	836,717	354,761	1,191,478
Jul-01	577,518	258,500	836,018
Aug-01	517,040	246,477	763,517
Sep-01	572,198	258,491	830,689
Oct-01	1,006,272	318,663	1,324,935
Nov-01	1,641,031	541,263	2,182,294
Dec-01	2,306,827	788,984	3,095,811
Total 2001	25,026,575	9,213,890	34,240,465
Percent	73%	27%	100%

Source: AE 1-4

If the Department approves Bay State's proposal, it will essentially assign all of Bay State's customers to the Company's incentive program, at no cost to Bay State. Customers will not be able to affirmatively choose to go into the program; they will be placed in the program without a choice, an advantage that suppliers do not have. Suppliers cannot acquire customers without customer's specific authorization. Obtaining that authorization carries a cost.

In Affiliate Rules, D.P.U. 96-44 (1996), the Department developed rules to prevent an LDC from giving its retail affiliate preferential treatment, and to prevent cross-subsidization of competitive services.

> The Department also noted that the potential for undue preference and favorable treatment of a competitive affiliate and its customers by a regulated utility threatens the development of a competitive marketplace. The purpose of the proposed regulations…is to ensure that all gas and electric suppliers and all customers are subject to the same rules, have access to the same information, and are treated equally by the regulated utility and its employees responsible for the distribution of energy services.

Affiliate Rules D.P.U. 96-44 (1996) at 1. Bay State's proposal bypasses the affiliate route and asks the Department to give the Company itself preferential treatment over all of its competitors. No rules can be put in place to cure this circumstance other than to reject the company's proposal.

If Bay State is not willing to use its expertise to offer a risk-managed product in the competitive market (Tr. 2, at 147-151), there must be subsidies inherent in offering it on a monopoly basis. In fact, there are subsidies. These subsidies have been identified as avoidance of acquisition costs, billing costs, and administration costs, elimination of volume risk, and recovery of prior year's level of supply reservation charges. Tr. 3, at 151, 155; Ex. AE-1, at 8, 11. Bay State must not be allowed such preferential treatment. Because Bay State's proposal violates the Department's criteria that incentive proposals be consistent and enhance with market-based competition and because it violates the Department regulations prohibiting LDCs from giving discriminatory preference to its competitive operations (220 CMR 12.00 et seq), it should be denied.

C. Incentive Proposals Should Focus On Comprehensive Results.

In Incentive Regulation, D.P.U. 94-158 (1995), another criteria the Department established to use to evaluate an incentive proposal was "Focus on Comprehensive Results." The Department stated:

> Although the Department does not prescribe or endorse a specific mechanism in this Order, *broad-based mechanisms appear in general to better complement a competitive marketplace.* The Department acknowledges that there may be some areas of utility operations, such as DSM and environmental compliance, that broad-based incentive mechanisms may not be able to fully address. In these instances, the use of targeted incentives within the context of a broad-based incentive proposal may be appropriate. *Petitioners seeking to include targeted incentive mechanisms must identify the specific policy objective intended to be met by the targeted incentive, demonstrate why a broad-based proposal otherwise fails to meet those particular needs, and show that any inconsistency between the plan and its overall goals is minimized*. The Department does not wish to

> preclude targeted incentives per se, but encourages petitioners to demonstrate how targeted incentives could complement a comprehensive plan to control overall costs and improve service. If a utility opts to submit a narrowly targeted incentive proposal, the petitioner must satisfactorily address the concern that it may create perverse incentives.

Id., at 62-63 (emphasis added).

Bay State's proposal is specifically targeted at domestic pipeline and storage commodity, and does not include all of the risks and costs associated with selling and delivering gas commodity in a retail market. Exh. AE-1, at 9, 11; Tr. 3, at 151, 155. A broad-based incentive would focus on all gas costs required to purchase and deliver gas to the LDC's city gate, including all commodity, capacity and administrative costs – **all** the costs included in the CGA. That is the product that is offered in the competitive market. Bay State has instead decided to focus its efforts on only one element of delivered gas, and that element is domestic commodity. Exh. BSG-4. All other costs are passed through to customers through the CGA and could change in a number of different ways as a result of this incentive proposal, which may or may not benefit customers as a result of the commodity incentive. Dispatch of resources for Bay State if its proposal is approved will now have a new element – to maximize commodity incentives – and that could be in conflict with least cost dispatch. The Department should take away Bay State's reconciliation mechanism, and include demand charges and net all administrative costs against gross margins as a condition on earning gas cost incentives if Bay State is to be put on an equal footing with competitive suppliers.

Additionally, Bay State has significant capacity decisions arising during the term of the proposed GCIM. Exh. AE 1-15. Bay State could game those capacity decisions in a way to attempt to maximize commodity incentives (Exh. AE-1, at 12), for example, instead of turning back zone 1-3 capacity and buying gas at zone 4, the company could keep all of its long-haul capacity, for which it is not at risk, and buy gas at zone 0 or 1, incurring additional capacity costs in order to earn on commodity at that point. This type of potential gaming is precisely why the Department in its wisdom advocated broad-based incentive mechanisms. The Department should reject the Company's proposal because it is not a broad based incentive proposal and because it has the potential to produce unintended and undesirable results on overall delivered gas costs.

III. BAY STATE'S PROPOSAL DEVIATES FROM THE NATURE OF DEFAULT SERVICE.

The market for wholesale natural gas is a competitive one. There are many buyers and many sellers of the commodity and there is sufficient information relative to price discovery to make the market efficient. Exh. BSG 1, at 7-9. Customers of Bay State are paying a market price for their gas as evidenced by the Company's past three years of commodity purchasing. Exh. AE 1-7. The current paradigm is consistent with the policy articulated in the Electric Restructuring Act by the Legislature and the Department's regulations concerning default service.

Bay State's proposal will stretch the notion of default service by allowing the Company to earn a profit on delivered commodity, and also to speculate on price with ratepayer money. Since we know that the market is competitive, and Bay State does not know on a given day what the actual benchmark index is going to be the next day or any day in the future, it will be making an educated guess, or speculating, on the direction of market prices (Tr. 1, at 42-43; Exh. BSG 1, at 15-16), something it would not likely do in the absence of ratepayer revenues and gas throughput. Even though Bay State has proposed to hold ratepayers harmless,[3] this is not the type of business the Department should be encouraging a public utility to enter.

[3] In any event, Bay State's proposal does not hold the ratepayer harmless. As noted above, there is the possibility of gaming, which – although not clearly visible – will increase ratepayer gas costs. More importantly, Bay State's

With respect to the use of financial instruments and hedging, we should wait until the Department makes its decision in Use of Risk Management Techniques, D.T.E. 01-100. The existing CGA program, modified to allow LDCs to use short-term hedges to manage volatility, would be a better way to achieve price stability and avoid winter price spikes. Bay State's current proposal will not necessarily address price spikes.

Bay State could also employ some of the strategies it is proposing absent incentives. For example, Bay State could employ a delayed injection strategy without its proposal and without using financial instruments. This strategy is currently available to the Company under existing regulation. Tr. 2, at 171-172. Here Bay State is asking for an incentive for something it could have, and should have, done in the past. Although Bay State hides behind the argument that it has not pursued some of these strategies due to risks of being found imprudent, Bay State is already at risk for losses or "above market" purchases, whether or not its proposal is approved. Tr. 2, at 180-185.

Finally, Bay State does not intend to include the administrative costs of its program in the CGA until after its next base rate case, which is not likely to go into effect until the end of the term of the program. Exh. BSG 3, at 10; Tr. 2, at 165. This is yet another element that will skew the price that customers use as the price to compare against a supplier's offering.

It is clear that this proposal stretches the intent of default service, and as a policy matter, the Department should not allow LDCs to profit from price speculation in the financial markets.

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proposal does not hold the ratepayer harmless because it precludes competitive alternatives for ratepayers. As the Department stated, " Where customer choice can be enhanced, the Department will continue to rely on expanding the number of market based solutions." Incentive Regulation, D.P.U. 94-158 (1995), at 58.

IV. CONCLUSION

Bay State's GCIM proposal is in direct conflict with Department policy and violates Department regulation prohibiting an LDC from giving undue preference to its competitive operations. If approved, Bay State's proposal will present a bona fide threat to the competitive market on Bay State's system, and will forge unsteady new ground in the Company's use of ratepayer revenues to speculate in the physical and financial commodity markets for profit. The Department should see through the minor benefits that could accrue to the captive residential market and protect the competitive markets that exist by rejecting Bay State's proposal out-of-hand. This proposal flies in the face of all of the efforts the Department is making in the electric industry to encourage competition. Approval of such a program could put a chill on programs in both the gas and electric industries.

For all of the reasons above, AllEnergy urges the Department to continue its support of competitive markets as a better way of providing customers with value by rejecting the Company's proposed GCIM.

Respectfully submitted,

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